To: NVCA Membership

From: NVCA Standards Committee

Re: Recommended Trading Practices

Date: **April 11, 2011**

INTRODUCTION

Activity in the secondary market for securities of venture-backed companies has been on the rise based, in part, on the development of secondary trading platforms. At the same time, in the wake of recent economic events, the alternative investment funds industry has been subject to heightened regulatory scrutiny as evidenced by legislation such as the Dodd-Frank Act, the Volcker Rule and the EU AIFM Directive. The venture capital industry has been identified, in large part, as an industry segment that does not involve risks to investor protection or systemic risks to the financial markets – risks against which these rules were intended to protect. In fact, the venture capital industry has been viewed as a positive force in the economy, giving rise to new companies, additional jobs and innovative technologies. These factors have allowed the venture capital industry to obtain exemptions from certain regulatory constraints to which other funds are subject. The industry has not, however, emerged untouched. Regulation will still affect the venture capital industry, although in many cases to a less significant extent than other industry sectors.

The NVCA believes it is important for the venture capital industry to continue to be a responsible market participant, based on its actual contributions to the nation's economy, in order to allow it to continue to flourish without undue burdens or impediments. Part of the mission of the NVCA, as the trade association to the venture capital industry, involves identifying topical issues to accomplish this goal.

The NVCA understands that the decision of a venture capital *fund* to invest in portfolio companies is determined within the investment discretion and business judgment of the venture capital fund's general partner. This memorandum does not address those fund investment decisions. In this memorandum, however, the NVCA would like to highlight factors that a venture capital *firm* should consider when its *partners or employees* decide whether to invest individually in companies, regardless of whether those companies are portfolio companies of the firm's venture capital funds.

RECOMMENDATION

The NVCA recommends that every venture capital firm have a policy, tailored to its organization, regarding investment activity by that firm's partners and employees. That policy should include discussion of the individuals' and the firm's obligations under federal securities laws, contractual obligations to limited partners and fiduciary duties, as well as delineation of any approvals that may be required by limited partners. The purpose of including such criteria in a policy would be to ensure that sufficient information about the individuals' and the firm's obligations to their funds and investors could be appropriately assessed, to the extent those obligations are intended to protect the funds and investors from being disadvantaged by such non-fund-related investment activity.

Depending on the nature of each particular firm, policy options that may be appropriate include the following:

- Notification to the firm of a partner's or employee's individual investment activity.
- Prohibition by the firm of individual investment in particular areas (e.g., geographic, sector, stage).
- Pre-approval by the firm of any individual investments and/or waivable prohibitions of particular types of individual investments.
- Non-waivable prohibition of individual investments.

DISCUSSION

Prohibition on Insider Trading

Both private and public company investments made by venture capital firm partners and employees may be subject to various federal securities laws. For example, Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 – the general anti-fraud securities rules – apply to prohibit illegal insider trading in either private or public securities. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. It also may include "tipping" such information, securities trading by the person "tipped", and securities trading by those who misappropriate such information.

Severe penalties may be imposed on an individual as a result of his or her illegal insider trading activity. Penalties may also be imposed on a "controlling person" of an individual who commits insider trading violations, such as a venture capital firm in connection with illegal insider trading activity committed by certain of its personnel. Consequences imposed on individuals or firms may include:

- Criminal sanctions which may include fines of up to $5,000,000 and/or up to 20 years imprisonment.
- Civil penalties which may include disgorgement of profits and up to the greater $1,000,000 or three times the amount of profits gained or losses avoided by the individual.
- Permanent bar from acting within the securities industry by the SEC.
- Restrictions on the firm's ability to conduct certain of its business activities.
- Lawsuits by investors seeking to recover damages for insider trading violations.

In addition to insider trading, Sections 13 and 16 of the Exchange Act require reporting and may impose limitations on certain public company holdings that could apply to partners or employees of venture capital firms.

A monitoring system by a venture capital firm of its personnel's individual investment activity, in addition to a firm's general educational program, may assist in compliance with any such applicable federal securities laws.

Contractual Restrictions and Fiduciary Obligations

Venture capital fund limited partnership agreements vary significantly, but they typically include provisions outlining certain obligations of the general partner (including, for this purpose, certain of the venture

capital firm's partners or employees) to the fund's limited partners. The specific requirements imposed on any general partner generally result from negotiations with the fund's limited partners.

Some of these agreements require that the general partner and some or all of such individuals (i) devote a certain amount of their business time to the affairs of the venture capital fund; (ii) make available to the venture capital fund investment opportunities that are appropriate to that fund; (iii) place the financial interests of the venture capital fund before their own financial interests; or (iv) avoid, or seek approval from some or all of the limited partners regarding, conflicts of interest. In general, these obligations are similar to fiduciary obligations that may be imposed on the general partner and such individuals by statute. In some cases, such limited partnership agreements also include specific limitations on the ability of the general partner and such individuals to own securities of the fund's portfolio companies.

Venture capital firms that manage funds whose partnership agreements include such contractual restrictions or impose such fiduciary obligations should consider how best to ensure compliance. In particular, the firm may want to consider a process to ensure that investment activity by the firm's partners or employees – including in companies that are not fund portfolio companies – does not run afoul of these obligations. For example, the acquisition of an interest in a private company that is a potential competitor, target or acquirer of a portfolio company of the firm's venture capital funds may or may not give rise to such a contractual restriction or fiduciary obligation.

In order to make such determination, the investing individual must be aware of any such obligations. A system – either to educate the firm's key personnel as to the potential issues that may arise from personal investment activity or to increase awareness of the personal investment activity of a firm's key personnel – likely is warranted in many situations.

Advisers Act

Under the Advisers Act, registered investment advisers (RIAs) must adopt a code of ethics to help prevent fraudulent conduct in securities transactions and are subject to specific notice and record-keeping requirements for securities transactions by certain RIA personnel. Unregistered advisers, while subject to the anti-fraud provisions of the Advisers Act, are not subject to the specific requirements applicable to RIAs to ensure such compliance.

The venture capital industry was successful in retaining an exemption from registration under the recent Dodd-Frank Act legislation. Although the definition of "venture capital fund" is still in process, the NVCA does not suggest that unregistered investment advisers to venture capital funds should be subject to the mandatory compliance obligations imposed on RIAs in connection with individual trading activity. Rather, the NVCA believes that such mandatory compliance requirements may be disproportionate to the level of risk associated with a venture capital firm's investment activity.

The Advisers Act, while not controlling, provides analogous requirements to facilitate the RIA's assessment of whether an individual's investment activities present a conflict of interest that might disadvantage the RIA's clients. The code of ethics – compliance with which is subject to routine examination by the SEC – must set forth, among other things:

- Standards of conduct expected of advisory personnel.
- A system of pre-clearance for investments in initial public offerings and private placements by so-called "access persons" – *i.e.*, the RIA's supervised persons who have access to information regarding the RIA's recommendations of purchases or sales of securities or portfolio holdings.

- A requirement that all violations of the code be promptly reported to the chief compliance officer or another designated person.
- A requirement that access persons and certain family members periodically report their personal securities transactions and holdings in securities (other than certain classes of securities, such as U.S. government securities, money market instruments, and shares or units in unaffiliated mutual funds).

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It is important to remain in touch with your professional advisors who are familiar with the obligations that may be imposed on your firm and its personnel under your governing documents and state, federal or another jurisdiction's governing law and that may affect your firm's individual trading policies.